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FEDERAL COMMUNICATIONS COMMI
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Access Charge Reform	)	CC Docket No. 96-262

PETITION FOR RECONSIDERATION OF FOURTH REPORT AND ORDER IN CC DOCKET NO. 94-1 AND SECOND REPORT AND ORDER IN CC DOCKET NO. 96-262 <u>FILED BY CITIZENS UTILITIES COMPANY</u>

CITIZENS UTILITIES COMPANY

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SUMMARY

The Citizens LECs' petition for reconsideration demonstrates that the *Price Cap Order's* application of a 6.5% productivity factor to rural telephone companies, as defined in Section 3(47) of the Act, that have elected price cap regulation ("rural price cap LECs")[1] must be reconsidered because:

1. the 6.5% productivity factor is based solely upon inapposite Bell Operating Company experience and data under price cap regulation;

2. it is inconsistent with the transitional treatment accorded rural telephone companies in the *Universal Service Order*;

3. it impedes the ability of rural price cap LECs to meet their universal service obligations under Sections 254(b)(1), (2) and (3) of the Act; and

4. it is arbitrary and capricious.

The Citizens LECs propose two alternative remedies, both of which call for suspension of application of the 6.5% productivity factor to rural price cap LECs during the pendency of an expedited, rural LEC-specific price cap further rulemaking proceeding. The essential difference between the two alternatives is that one proposes interim continuation of the status quo *ante* interim price cap plan, while the other proposes use of the former 5.3% productivity factor, with no sharing, but with a 10.25% low-end adjustment.

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[1] The Citizens LECs are the only pure rural price cap LECs at this point in time.

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SECOND REPORT AND ORDER IN CC DOCKET NO. 96-262
FILED BY CITIZENS UTILITIES COMPANY

Citizens Utilities Company, on behalf of itself and its incumbent local exchange telecommunications subsidiaries (hereinafter referred to, collectively, as the "Citizens LECs"), by its attorney, pursuant to Section 405 of the Communications Act of 1934, as amended, 47 U.S.C. §405 (the "Act"), and Section 1.429 of the Commission's Rules, hereby petitions for reconsideration of the Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262 (hereinafter referred to as the "*Price Cap Order*"),[1] and shows as follows:

I. The Citizens LECs Are "Interested Persons" Entitled To File A Petition For Reconsideration

The Citizens LECs meet each of the qualifications of Section 405 of the Act and Section 1.429(a) of the Commission's Rules for standing to file a petition for reconsideration.[2] First,

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[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, CC Docket Nos. 94-1 and 96-262, FCC 97-159, rel. May 21, 1997.

[2] Section 405 grants standing to file a petition for reconsideration of an FCC order or decision to "any party thereto, or any other person aggrieved or whose interests are adversely affected thereby," while the Section 1.429(a) standing qualification criterion is that of "any interested person."

Citizens Utilities Company, on behalf of the Citizens LECs and all of its other telecommunications subsidiaries, is a party in the CC Docket No. 96-262 proceeding (the "Access Reform Proceeding").[3] The Citizens LECs, whose price cap election became effective on July 1, 1996, filed no pleadings in the stages of the CC Docket No. 94-1 proceeding that preceded the *Access Reform Notice.*[4] The *Access Reform Notice* and the *Price Cap Order* had the effect of consolidating the CC Dockets No. 94-1 and 96-262 proceedings. Accordingly, the Citizens Utilities' comments filed in response to the *Access Reform Notice* must be deemed to be part of the record in the CC Docket No. 94-1 proceeding.

Second, as demonstrated below, the Citizens LECs are aggrieved and adversely affected by the *Price Cap Order*.

II. Background

In their comments in the Access Reform Proceeding, at page 13, the Citizens LECs pointed out that,

> [T]he Citizens LECs are the only LEC group to elect price cap regulation since issuance of the Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858 (1995). Price cap regulation has not proven to be particularly attractive. Only a few LECs with the option to remain under rate of return regulation have selected the price cap alternative. The federal price cap system continues, in the form of the "sharing mechanism," a discomfiting form of rate of return regulation. The sharing mechanism creates the same disincentive to achieving operating efficiency that exists in rate of return regulation, albeit in a somewhat less severe form. The Citizens LECs, fully understanding the infirmities of the price cap regime, made their election believing that price cap regulation was, under the

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[3] *See* Access Charge Reform, Notice of Proposed Rulemaking, CC Docket No. 96-262, Price Cap Performance Review for Local Exchange Carriers, Third Report and Order, CC Docket No. 94-1, FCC 96-488 (rel. Dec. 24, 1996) (the *"Access Reform Notice"*).

[4] It should be noted that the Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1,10 FCC Rcd 13659 (1995) (the *"Fourth Further NPRM"*), was the request for comments most immediately preceding the *Access Reform Notice*. It was released on September 27, 1995, almost one year before the Citizens LECs became price cap regulated.

> circumstances, marginally more attractive. Many other carriers have reached a contrary conclusion, which is arguably a referendum on how well price cap regulation is working.
>
> The Commission should, in the course of the *Access Reform NPRM* deliberations, ask why more LECs have not elected price cap regulation. More to the point, it should ask whether the rules that are promulgated in this proceeding will make price cap election any more or less attractive. Done incorrectly, those rules may make price cap regulation even less attractive to other LECs. As a representative of rural LECs, the Citizens LECs believe that the course of future price cap regulation must be tailored with recognition that what is appropriate for the BOCs and GTE may not be appropriate for rural price cap LECs. The Commission should take steps to make price cap regulation more, not less, attractive to the large universe of LECs that have so far rejected it. Key among these steps is elimination of the sharing mechanism, at least for rural price cap LECs. At a minimum, the Commission should reject for small LECs an over-broad "market-based" or "prescriptive" regulatory approach that can only serve to make price cap regulation an even less attractive proposition for the many carriers that have not embraced it [footnotes omitted].

While the *Price Cap Order* does have the salutary effect of eliminating sharing obligations, it also is permeated by the fatal flaw of paramount concern to the Citizens LECs -- all price cap LECs are dragged into a "one size fits all" price cap regime. The *Price Cap Order's* selection of a single 6.5% productivity factor is based purely on historical data from the Bell Operating Companies ("BOCs").[5] As such, it is inapposite to the circumstances of the dramatically smaller rural LECs. The Citizens LECs are the only price cap regulated entities comprised solely of rural telephone companies, as defined in Section 3(47) of the Act. In this petition, rural telephone companies, as defined in Section 3(47) of the Act, that come under price cap regulation will be referred to as "rural price cap LECs." As discussed more fully below, the Citizens LECs expect that the new mandatory productivity factor, if allowed to stand for rural price cap LECs, will have adverse universal service impacts, including hindering their continued ability to make the capital expenditures necessary to

[5] *See Price Cap Order* at ¶ 135 and Appendix D, p. 2.

provide the state-of-the-art telecommunications services that their rural customers deserve. Certainly, the Commission's failure to consider the circumstances of rural price cap LECs in the *Price Cap Order* can only serve to make price cap regulation an even less palatable choice for the large universe of LECs remaining under rate of return regulation.

III. Grounds For Reconsideration Of The *Price Cap Order*

A. Application of a 6.5% productivity factor to rural price cap LECs is inappropriate because it is based solely upon inapposite BOC experience and data.

B. The *Price Cap Order's* immediate extension of a 6.5% productivity factor to rural price cap LECs is inconsistent with the transitional treatment accorded rural telephone companies in the *Universal Service Order.*[6]

C. The *Price Cap Order's* extension of a 6.5% productivity factor to rural price cap LECs may result in a material, adverse impact upon rural customers, in violation of at least three principles animating Congressional universal service goals, by impeding:

   (1) the provision of quality services in rural and high cost areas at just, reasonable and affordable rates;

   (2) access to advanced telecommunications services in rural and high cost areas; and

   (3) consumer access in rural and high cost areas to telecommunications and information services that are reasonably comparable to those provided in urban areas, at reasonably comparable rates.[7]

D. The *Price Cap Order's* application of a 6.5% productivity factor to rural price cap LECs is arbitrary and capricious.

The arguments in support of the forgoing grounds for reconsideration are found in Section VI, *infra*.

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[6] Federal-State Joint Board on Universal Service, First Report and Order, CC Docket No. 96-45, FCC 97-157, rel. May 8, 1997 (the *"Universal Service Order").*

[7] Sections 254(b)(1), (2) and (3) of the Act, respectively.

IV. The Citizens LECs Pose Two Alternative Forms Of Relief From The *Price Cap Order's* Inappropriate Application Of A 6.5% Productivity Factor To Rural Price Cap LECs

A. Alternative One

1. Suspension of application of the 6.5% productivity factor to rural LECs and interim application of rural price cap LEC's pre-*Price Cap Order* productivity factor election;

2. promulgation of a Further Notice of Proposed Rulemaking to gather the necessary data to develop a rural LEC-specific productivity factor and to explore the issue of whether the Total Factor Productivity methodology is appropriate for such LECs; and

3. institution of a rural LEC-specific price cap plan within no more than one year after promulgation of the Further Notice of Proposed Rulemaking.

B. Alternative Two

1. Imposition of an interim 5.3% productivity factor, without sharing, but with a 10.25% low-end adjustment mechanism, upon rural price cap LECs;

2. promulgation of a Further Notice of Proposed Rulemaking to gather the necessary data to develop a rural LEC-specific productivity factor and to explore the issue of whether the Total Factor Productivity methodology is appropriate for such LECs; and

3. institution of a rural LEC-specific price cap plan within no more than one year after promulgation of the Further Notice of Proposed Rulemaking.

V. The Commission Should Exercise Its Discretion Under Section 1.429 (b)(3) Of Its Rules To Review Facts Not Previously Presented

In Section VI and Attachment 2, *infra*, the Citizens LECs present company-specific factual data to demonstrate both the flaws inherent in imposing a 6.5% productivity factor upon rural price cap LECs and the adverse impact that this productivity factor will have upon the Citizens LECs' continued ability to invest in rural infrastructure to meet their universal service obligations. In their comments filed in the Access Reform Proceeding, the Citizens LECs showed that they are the only enterprise comprised solely of rural telephone companies, as defined in Section (3)(47) of the Act, that is price cap regulated. Further, they showed that rural LECs share none of the characteristics of the more typical price cap LECs, such as the BOCs or GTE, and, accordingly, should not be swept up into a "one size fits all" regulatory approach.

The Citizens LECs are late comers to price cap regulation. Their price cap election became effective with their interstate access tariff filing on July 1, 1996. The pleading cycle for the *Fourth Further NPRM* had long since closed and, at the time of the pleading cycle in the Access Reform Proceeding, the Citizens LECs had approximately six months' experience under price cap regulation. As a practical matter, the Citizens LECs had no realistic opportunity to submit reliable data to support the proposition that the long-term, permanent price cap plan should feature multiple X-Factors to accommodate, " . . . variations among the LECs' service regions with respect to level of growth in the overall economy, the proportion of rural and urban areas for which service is provided, and level of competition in the provision of telecommunications services."[8]

As shown below, the inappropriate application of the 6.5% productivity factor to rural price cap LECs will, in the case of the Citizens LECs, have a material, adverse impact upon their ability to invest in rural America and, ultimately, their universal service obligations. Because of the universal service implications raised by the Citizens LECs, the public interest requires that the Commission review and consider the factual matters presented herein.

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[8] *Fourth Further NPRM* at ¶ 109.

VI. Argument

A. Introduction

It is clear that the Commission relied solely upon historic BOC data in its TFP methodology to arrive at the prescribed 6.5% productivity factor.[9] Why only BOC data was used was never explained in the *Price Cap Order.* Sections VI(B) and (C), *infra,* show, respectively, that extension of the 6.5% productivity factor to rural LECs is inappropriate and violative of universal service principles and policies embodied in both statute and the FCC's own decisions. The arguments in Sections VI(B) and (C), *infra*, address the flaws and practical impact of the erroneous decision to apply the 6.5% productivity factor to rural price cap LECs, assuming, *arguendo*, that the decision is even a valid exercise of the Commission's rulemaking power. Section VI(D), *infra,* suggests that it is not.

B. Application Of A 6.5% Productivity Factor To Rural Price Cap LECs Is Inappropriate

1. The *Price Cap Order's* Total Factor Productivity Analysis Is Limited In Scope To the BOCs And Does Not Reflect The Reality Of Rural LEC Markets

The Citizens LECs have commissioned a study of the *Price Cap Order's* Total Factor Productivity ("TFP") analysis used to arrive at the new 6.5% productivity factor for price cap LECs. The Declaration of Dr. Victor L. Andrews (the "Andrews Declaration") is appended as Attachment 1 hereto and incorporated by reference into this petition.

Dr. Andrews' study of the *Price Cap Order's* TFP analysis illustrates a crucial point in the chain of logic suggesting the error of extending the 6.5% productivity factor to rural price

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[9] *See* fn. 5, *supra.*

cap LECs -- a primary output driver in the analysis was the level of interstate access growth experienced by the BOCs.[10] The BOCs serve the preponderance of the urban and suburban markets where the bulk of customers that generate interstate traffic at located. In contrast, rural LECs such as the Citizens LECs generally serve no urban areas or other concentrations of high volume long distance customers. Accordingly, overall demand for interstate long distance calling is far less elastic in rural, high cost markets than it is in the urban/suburban markets typically served by the BOCs. It does not take an economist to demonstrate this point -- the greatest demand stimulation for lower priced long distance minutes has been and will continue to be in the areas where the most potential customers are located.

A central, if unofficially stated, factor animating the 6.5% productivity factor appears to be the belief that the concomitant decreases in interstate access rates will dramatically increase demand for access services and, as a consequence, price cap LEC productivity. Dr. Andrew's study of the *Price Cap Order's* TFP analysis suggests, based on historical experience, that the vast preponderance of the resulting demand stimulation will be in BOC markets. While there may or may not be merit in the conclusion that the BOCs will be able to readily "grow" into the new 6.5% productivity factor as a result of interstate access stimulation, no record exists for making the same prediction for rural price cap LECs.

Dr. Andrews observes another flaw in the *Price Cap Order's* TFP analysis, as applied to both non-rural and rural price cap LECs. Dr. Andrews questions the extent to which the *Price Cap Order's* Appendix D, Chart 1 finding of a 2.20 percent differential between the BOCs and the U.S. Nonfarm Business Sector's input price growth rates between 1986 and 1995 was actually

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[10] Andrews Declaration at pp. 2-4; 8-10; 14-15; and 18.

attributable to the control of the BOCs' management. Further, Dr. Andrews expresses doubt about whether the BOCs' experience in input price changes for the period can be extrapolated to small LECs. For example, rural LECs do not have the economies of scale of BOCs and may lack the same level of purchasing power enjoyed by the BOCs.[11]

Finally, Dr. Andrews finds the *Price Cap Order* flawed by capital cost and depreciation estimates that are too low and productivity estimates and the resulting X-Factor that are too high.[12] These flaws permeate the *Price Cap Order* and suggest that the 6.5% productivity factor may be inappropriate for all price cap LECs, not just rural LECs.

2. The 10.25 % Low-End Adjustment Is Not A Meaningful Remedy For The Inappropriate Extension Of A 6.5% Productivity Factor To Rural Price Cap LECs

The Citizens LECs project that their composite rate of return under the 6.5% productivity factor will fall below 10.25% during the first and second quarters of 1998. *See* the Declaration of Mark T. Shine appended as Attachment 2 hereto and made a part hereof (the "Shine Declaration"). In the likely event that this projection proves accurate, the 10.25% low-end adjustment in the new price cap regime does not offer a meaningful remedy in that it is entirely prospective in nature.

Unlike the situation prevailing in rate of return regulation where estimation and projection are the norm, the low-end adjustment process in price cap regulation relies solely on historical experience. Thus, even though the Citizens LECs believe that application of the 6.5% productivity factor will drive their composite rate of return below 10.25% in the foreseeable

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[11] *Id.* at p. 6.

[12] *Id.* at pp. 15-17.

future, they cannot take advantage of the low-end adjustment until well after the fact. Affected carriers that cannot meet the 6.5% productivity factor may suffer returns well below 10.25% for up to a year before the low-end adjustment can be utilized.

C. Application Of A 6.5% Productivity Factor To Rural Price Cap LECs Is Inconsistent With Universal Service Principles And Policies

1. The Legal Issue

The Citizens LECs explained at length in their comments in the Access Reform Proceeding[13] that rural LECs are not comparable to the BOCs or GTE in terms of territories served, size or financial wherewithal. The stark differences between BOCs, GTE and rural LECs has practical and legal consequences. This should be as intuitively obvious in price cap regulation as it was in the *Universal Service Order.* In the later case, the Commission concluded that rural LECs should move toward high cost funding based upon forward-looking economic costs on a slower, more deliberate track than for non-rural carriers based upon a finding,

> [T]hat compared to large ILECs, rural carriers generally serve fewer subscribers, serve more sparsely populated areas, and do not generally benefit as much from economies of scale and scope. For many rural carriers, universal service support provides a large share of the carriers' revenues, and thus any sudden change in the support mechanisms may disproportionately effect rural carriers' operations. Accordingly, we adopt the Joint Board's recommendation to allow rural carriers to continue to receive support based on embedded cost for at least three years.[14]

Unfortunately, the *Price Cap Order* does not reflect the same alacrity in recognizing and protecting the interests of telecommunications consumers in rural

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[13] *See* Citizens Utilities Company's comments in the Access Reform Proceeding, at Section II(A).

[14] *Universal Service Order* at ¶ 294.

America that the Commission displayed in the *Universal Service Order*.[15] While it may be correct that the present record underlying the *Price Cap Order* lacks rural LEC-specific data, the same was true in the record underlying the *Universal Service Order*. The same relative lack of rural LEC economies of scale and scope and other differences between rural and non-rural LECs that animates the "go slowly and deliberately" approach to reform of rural LEC universal service funding should also animate the Commission's approach to rural LEC price cap regulation issues. The need to proceed with care and deliberation in addressing price cap regulation issues in rural America is inextricably tied to rural universal service issues. The inconsistency between the *Price Cap Order's* and the *Universal Service Order's* respective treatment of rural LEC issues must be remedied.

2. The Practical Issues

The Shine Declaration shows the aggregate impact of the application of the 6.5% productivity factor, access and universal service reform and mandated investment pursuant to the Telecommunications Act of 1996 and FCC implementation decisions, upon the Citizens LECs. In summary, a great strain is placed upon the ability of the Citizens LECs to meet applicable universal service goals, including the goal of bringing advanced telecommunications services to rural America. Mr. Shine presents facts and figures painting a very sobering picture of the plight of rural LECs and

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[15] The *Universal Service Order's* distinction between rural and non-rural LECs is far from the only example of a "small LEC/large LEC" dichotomy in the applicable law and FCC regulation. *See, e.g.*, Section 251(f) of the Act (the Section 251(f)(1) authority for "exemptions, suspensions and modifications" from certain interconnection requirement for Section 3(47)-defined rural telephone companies and the Section 251(f)(2) authority for "suspensions and modifications" of certain interconnection requirements for "less than 2%" LECs); and Sections 32.11 and 64.903(a) of the Commission's Rules, which draw a bright line, based on operating revenues, between large and small carriers in terms of accounting and CAM/ARMIS requirements, respectively.

the communities they serve under a price cap regulatory scheme designed with only the BOCs in mind.

The 6.5% productivity factor that is the gravamen of this petition must be viewed in the appropriate context. That context includes the array of incumbent LEC capital investment mandated by the Act and FCC implementation rules. As suggested in the Shine Declaration, this mandated capital investment is required to implement the following:

1. single-party service upgrades required as a condition precedent to universal service eligibility;[16]

2. intraLATA equal access deployment (required by August 8, 1997 for the Citizens LECs because of their affiliation with an interexchange carrier);[17]

3. reciprocal transport and termination;[18]

4. information service changes needed to bill differential levels of End User Common Line and Prescubscribed Interexchange Carrier Charges;[19]

5. local number portability; [20]

6. provision of wholesale local exchange services to resellers; [21] and

7. provision of unbundled network elements to local exchange competitors.[22]

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[16] Sections 54.101(c) and .201(d)(1) of the Commission's Rules.

[17] Section 251(b)(3) of the Act; Section 51.211(c) of the Commission's Rules.

[18] Section 251(b)(5) of the Act; Section 51.703 of the Commission's Rules.

[19] Sections 69.152 and .153 of the Commission's Rules.

[20] Section 251(b)(2) of the Act; Section 52.23 of the Commission's Rules.

[21] Section 251(c)(4) of the Act; Section 51, Subpart G of the Commission's Rules.

[22] Section 251(c)(3) of the Act; Sections 51.307, .309, .311,. 313, .315, .317, .319, and .321.

The enormity of the impact of the 6.5% productivity factor and mandated capital investment has forced reexamination and retrenchment of the Citizens LECs' capital investment plans in rural America. The Shine Declaration provides the numbers and they are large. The Shine Declaration also describes the painful capital reallocation process that the Citizens LECs are compelled to follow. In summary, the Citizens LECs are forced to focus their limited capital dollars upon mandated investment at a time when a significant revenue stream -- interstate access charges -- is being cut by the inappropriate application of the 6.5% productivity factor to rural price cap LECs. As painful as this process is for the management and shareholders of Citizens Utilities Company, it can also have consequences upon the provision of universal and advanced telecommunications services in the communities in rural America served by the Citizens LECs.

The universal service implications of the plight of the Citizens LECs are several. First, as the Shine Declaration shows, the Citizens LECs may have to forego universal service eligibility in several properties because of the enormity of capital investment required to upgrade all lines to single-party service. The investment, if made, could necessitate local rate increases and/or have a major impact upon universal service funding. The enormous investment level shown by Mr. Shine for single-party service upgrades is for the minimal level of technology required. This technology will not support such modern services as modem, telecopier and Internet usage. The decision making process is complicated by the uncertainty of investment recovery in a universal service system that will be "capped" for the foreseeable future.[23]

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[23] Shine Declaration at pp. 8-12; *Universal Service Order* at ¶ 302.

Second, a combination of a 6.5% productivity factor-driven drop in interstate access revenues and mandated capital spending means that the Citizens LECs are delaying or eliminating investment in facilities upgrades required to provide advanced telecommunications services in many communities. Mr. Shine points out that much of the non-mandated capital spending that is being cut would have gone to upgrading outside plant to the digital facilities needed to afford advanced telecommunications services in the affected rural communities.[24] Section 254(b)(2) of the Act, which states the universal service principle that advanced services should be provided in all regions of the Nation, is clearly implicated, as it is in the case of single-party upgrades. Investment in non-mandated facilities, when made, enhances the Citizens LECs' efficiency and ability to become more productive. Further, the old, outmoded plant that would otherwise be replaced is inherently less reliable than modern digital facilities. Service deterioration may follow. Investment in interconnection-related facilities, while mandated by law and regulation, does little to enhance the investing carrier's productivity. The competing demands for capital expenditure embodied in regulatory mandates, coupled with revenue losses flowing from the new 6.5% productivity factor, make it all the more difficult for the Citizens LECs to do the thing required to prosper under the current price cap regime --- becoming more productive.

The Shine Declaration also discusses the Citizens LECs' expectation that the cash flow reductions caused by application of the 6.5% productivity factor to rural price cap LECs and other recent FCC actions will increase their capital borrowing costs. Over time, these increased borrowing costs function as a limit on the amount of capital that can be borrowed and ultimately

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[24] Shine Declaration at pp. 14-16.

invested in the Citizens LECs' rural properties.[25] If capital expenditure, in general, is an important input factor in TFP analysis, it follows that the cost of the capital expended has a clear and direct impact upon productivity. Dr. Andrews observes that, "[i]f capital cost has been estimated [in the Commission's TFP analysis] on the low-side, productivity and the X-Factor are estimated on the high side."[26] The Citizens LECs' increased capital costs will act as a limiting factor in their productivity improvement and may render it impossible to achieve 6.5% per year productivity growth.

Under the current state of affairs, the ability of the Citizens LECs to modernize plant in rural America may depend upon increased support from state and federal universal service funds and/or local exchange rate increases. Sections 254(b)(1) of the Act, which states the principle that "[q]uality services should be available at just, reasonable, and affordable rates," and Section 254(b)(3), which expresses the principle of comparability in services and rates between urban, rural and high cost areas, are clearly implicated.

The Commission can and should assist in avoiding these adverse impacts upon universal service principles and policies by revisiting the imposition of a 6.5% productivity factor upon rural price cap LECs. A rural LEC-specific productivity factor is fully consistent with, and in the opinion of the Citizens LECs, required by, Section 254 of the Act.

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[25] *Id.* at p. 16.

[26] Andrews Declaration at p. 17.

D. The *Price Cap Order's* Application Of A 6.5% Productivity Factor To Rural Price Cap LECs Is Arbitrary And Capricious

A cardinal principle of administrative agency rulemaking is that an, "agency must cogently explain why it has exercised its discretion in a given manner."[27] The agency decision must contain findings and analysis sufficient to show the basis upon which a decision was made[28] so that a reviewing court can "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error in judgment."[29] When measured against this cardinal principle, the *Price Cap Order's* selection of a 6.5% productivity factor for rural price cap LECs is arbitrary and capricious. The *Price Cap Order* does not contain any explanation of why this conclusion was made, much less contain any recitation of findings to support the conclusion.

The *Price Cap Order* findings and analysis relating to use of data of LECs other than the BOCs consists of a single paragraph, paragraph 135, which reads,

> USTA criticizes AT&T's model because it includes data only from the Bell Operating Companies (BOCs), while USTA's model includes data from GTE, Sprint, SNET, and Lincoln. USTA also finds, however, that including non-BOC data results in only a 0.1 percent difference in the X-Factor for the period from 1988 to 1994, and not different from 1989 to 1994. In our analysis of the record, we rely only on BOC data, as AT&T does.

The foregoing offers no clue why the Commission chose to use only BOC data. Did the Commission consider the possibility that the significance of data of the non-BOCs could be

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[27] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 48 (1983) [citations omitted].

[28] Burlington Truck Lines, Inc. v. U.S., 371 U.S. 156, 167 (1962).

[29] *Motor Vehicle Mfrs, supra,* at 458, citing Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc., 419 U.S. 281, 285 (1974); Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 416 (1971).

"averaged away" when consolidated with BOC data?[30] Why did the Commission fail or refuse to consider the non-BOCs data separately from that of the BOCs? Did the Commission examine the purported USTA finding that inclusion of the non-BOC data was statistically irrelevant, or, instead, did it merely take that purported finding at face value? Did the Commission consider that the non-BOC data presented by USTA did not include any data from rural telephone companies, as defined in Section 3(47) of the Act? Why did the Commission choose to rely exclusively upon BOC data? Is the universe of price cap LECs so "BOC-like" and homogeneous in size, service and demographic characteristics that BOC data can be relied upon as representative of the universe in TFP analysis? The *Price Cap Order* can be searched in vain for any indication that these questions were considered by the Commission.

The fatal legal flaw in the *Price Cap Order's* extension of the 6.5% productivity factor to rural price cap LECs is not salvaged by the claim that,

> [W]e find, contrary to the arguments of Sprint and US West, that multiple X-Factors are not necessary to be fair to LECs with productivity growth less that the industry average because the low-end adjustment mechanism provides adequate protection for those LECs. We also note that basing the X-Factor on industry average data is not inherently unreasonable.[31]

The fact that there may be a theoretical palliative for the misapplication of the 6.5% productivity factor -- the low-end adjustment -- does not cure the flaw inherent in the Commission's failure to justify its decision. *See Illinois Pub. Telecomm. Ass'n v. FCC,* No. 96-1394, 1997 U.S. App. LEXIS 16147, at *10, (D.C. Cir. July 1, 1997)(*per curiam*). That the

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[30] The Citizens LECs urge the FCC to avoid the trap of averaging BOC and non-BOC data in a further, rural LEC-specific price cap rulemaking proceeding. The sheer bulk of BOCs and their data will always overwhelm that of rural LECs.

[31] *Price Cap Order* at ¶ 160.

palliative is merely theoretical, at least in the case of the Citizens LECs, is demonstrated in Section VI(B)(2) and the Shine Declaration, *supra*.

Little consideration need be given to the *Price Cap Order's* citation of *Edison v. ICC*, 969 F. 2d 1221 (D.C. Cir. 1989) for the proposition that basing an X-Factor upon industry average data is not inherently unreasonable. For the proposition advanced, the citation is proper. However, it should be noted that administrative agency decisions, as a threshold matter, must contain findings and conclusions sufficient to justify the decision made. Unlike the Interstate Commerce Commission order the Court found reasonable in *Edison*, the *Price Cap Order* is remarkable for its failure to justify how or why its choice of industry average data was derived. Insofar as use of only BOC data to arrive at an X-Factor imposed upon both BOCs and non-BOCs is concerned, those findings and conclusions are utterly lacking. Accordingly, the extension of the 6.5% productivity factor to rural price cap LECs is, on its face, unreasonable and must be reconsidered.

VII. The Needed Relief

In Section IV, the Citizens LECs outlined the details of two alternative approaches to granting relief from the inappropriate application of the 6.5% productivity factor to rural price cap LECs. The only material difference between the alternatives is that the first would continue for a period of time the status quo *ante*, interim X-Factor plan for rural price cap LECs. The second alternative would impose the interim X-Factor plan's 5.3% productivity factor upon affected carriers with one material difference -- the arrangement would include a 10.25% low-end adjustment. Although it is less likely that rural price cap carriers would need to avail themselves of the low-end adjustment under a 5.3% productivity factor than under a 6.5% productivity factor, its availability is still necessary.

Both alternatives posed by the Citizens LECs contemplate further proceedings to address a rural LEC-specific price cap plan, during which time the interim arrangement mandated by the Commission would prevail for rural price cap LECs. These further proceedings are necessary to both gather rural LEC-specific data and examine whether the current TFP method needs to be modified to reflect the unique characteristics of rural LECs and the rural communities they serve. As noted in Section IV, *supra*, the Citizens LEC alternative proposals advance the principle that the rural price cap LEC-specific proceeding should move on a fast track, to be concluded within no more than one year from its inception.

VIII. Conclusion

The *Price Cap Order's* application of a 6.5% productivity factor to rural price cap LECs is deeply flawed in terms of both methodological development and practical impact upon rural America and is arbitrary and capricious. The Citizens LECs have presented both practical and legal reasons why application of the 6.5% productivity factor should be replaced by an interim productivity factor more congenial to rural price cap LECs during the pendency of an expedited, further rulemaking proceeding to arrive at an appropriate, rural LEC-specific productivity factor.

Congressional and oft-expressed FCC concerns with the needs of telecommunications consumers in rural America require no less.

Respectfully submitted,

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Attachment 1